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SUBJECT: Slovak/Euro parity revalued for an unprecedented second time

Reftel: Bratislava 216

1. (SBU) SUMMARY: At the request of the Slovak government the European Union revalued the Slovak koruna's central parity rate by 17 percent to 30.126 against the Euro from May 29. This is the outer edge of the previous parity of 35.44 set in March 2007, and creates a new band of 25.60-34.64 SKK/EUR. The change is designed to account for the strong appreciation of the koruna from 32.251 SKK/EUR when the European Commission recommended Slovak entry into the Euro zone on May 7, to 31.1 two days ago. A quick jump from 31.1 to 30.7 SKK/EUR on May 28 prompted the authorities to act. The surge has been fueled in recent weeks by heavy lobbying by Prime Minister Fico, with the implicit support of National Bank Governor Sramko, for a strong conversion rate. Both foreign and domestic exporters have remained quiet, leaving the lobbying to those in favor of a strong conversion rate. END SUMMARY.

GOS SUCCESSFUL IN PUSH FOR A STRONG KORUNA  
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2. (U) The Ministers of Finance from the Eurozone and the European Central Bank approved the request of Slovak authorities for a 17 percent revaluation of the conversion rate to 30.126, which was announced at 12:30 AM CET on May 29. This is the second time the official parity rate has been revalued, which is unprecedented in the history of Euro zone entry. Slovakia joined ERM II in 2005 at an original parity rate of 38.455 SKK/EUR, which was revalued by 8 percent on March 17, 2007 to 35.4424 SKK/EUR to account for Slovakia's strong economic growth, rising productivity and stable macroeconomic indicators. At the time the EC asked Slovakia to follow stricter fiscal policy to mitigate inflation pressures.

3. (U) Slovakia's economic growth has accelerated to 10.4 percent in 2007, and 8.4 percent in the first quarter of 2008. The koruna slowly appreciated from 2007, rising to 32.25 in advance of the EC's positive convergence report in early May. Following this assessment PM Fico made repeated statements arguing for a strong conversion rate to minimize the impact of Euro adoption on Slovak citizens and help reign in inflationary pressures (inflation increased to 3.7 percent in April from a low of 1.2 percent). The lobby for a strong conversion rate continued to grow, fueled by local analysts, with almost no counter arguments from the business sector, which would have the most to lose from a strong rate. Slovenska Sporitelna analyst Maria Valachyova noted that the koruna rate has been "enhanced by Slovak Government representatives supporting as strong a changeover rate as possible. Another positive aspect is the Slovak central bank's tolerance towards the strong koruna".

4. (SBU) In the lead-up to the revaluation the koruna moved closer to the bottom of the fluctuation limit of 30.126, at which the National Bank would need to intervene to keep within the Maastricht targets. The currency had reportedly been under pressure by currency traders over the past week. On the afternoon of May 28th, the Koruna reached the historic rate of 30.650 SKK/EUR, and was

traded at 30.730 SKK/EUR by the end of the day. The appreciation has been attributed to speculative trades totalling more than 500 million EUR coming from Slovak and Czech banks, with investors seemingly betting on a stronger conversion rate. Officially no important news from relevant authorities was released, though Eduard Pracko from OTB Bank postulated that some traders may have obtained insider information about a pending revaluation of the parity.

15. (U) At the opening of business May 30 the currency stood at 30.24 SKK/EUR, while the dollar had dropped to an all-time low of 19.44 SKK/USD, a 70 percent drop from November 2005 when Slovakia joined ERM II. Although many economic analysts are speculating that the new parity will be the final conversion rate, ING Bank's Jan Toth highlighted the fact that the EC surprisingly omitted any mention of the connection between the new parity and the conversion rate in its announcement. He is concerned that this could leave room for further speculation below the 30 SKK/EUR barrier.

#### INDUSTRY REACTION

16. (SBU) The Slovak business community has been surprisingly quiet in recent weeks, despite private comments to EmbOffs from individual companies that the strong appreciation of the koruna - more than 25 percent since joining ERM II in November 2005 - has cut into profit margins. Surprisingly, several business associations even appear to support the change. Jan Oravec from Association of Small and Medium entrepreneurs noted that he does not see strengthening Koruna as a threat for their members, because SME's are mostly in a role of suppliers to larger companies and do not realize international payments or transactions. Similarly, Martin Hostak from the National Employer's Association (RUZ) explained that large RUZ member companies are not disturbed by the strengthening Koruna. US Steel Kosice confirmed this sentiment, noting that the company's

financial transactions are kept in EURO, as US Steel is selling their products mainly to European customers.

17. (SBU) Tibor Gregor from Klub 500 acknowledged that member companies have been harmed by the more than 10 percent appreciation since the beginning of the year, but felt that the association was powerless to influence the government. Roman Kovac from Citibank thought that lower-added value, less-effective Slovak manufacturers will lose from the appreciation, but that the pricing pressures will create additional pressure on companies to raise productivity, a sentiment that was confirmed by Whirlpool during a recent visit to their factory. Many companies view the strong appreciation of the currency as secondary to the challenge of finding qualified labor, especially in Western Slovakia where unemployment has dropped considerably in recent years. Some analysts argue that a strong conversion rate may even help entice Slovak workers to return from abroad.

18. (SBU) COMMENT: The strong appreciation of the koruna in recent weeks was driven in large part by the strong push by PM Fico and the implicit support by NBS Governor Sramko. Fico has made it very clear that he wants to do all he can to minimize the affects of Euro adoption on the average citizen, regardless of the impact on the business community. The Prime Minister was clearly pleased with the size of the revaluation, noting that his government had achieved the "absolute maximum" that was possible to achieve with the European institutions. He said he would not comment on the conversion rate, stating that it will be determined based on ongoing discussions. Commercial banks and financial analysts do not think the exchange rate will break the psychological 30 SKK/EUR barrier, and estimate the final conversion rate to be around 30.3-30.6 SKK/EUR when it is set in July 2008. This is seen as an equilibrium range for the economy through the end of 2009. END COMMENT

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